

CALIFORNIA LOTTERY

Audit Report

ANNUITY INVESTMENT PROCESS

July 1, 2007, through June 30, 2009



JOHN CHIANG
California State Controller

September 2010



JOHN CHIANG
California State Controller

September 8, 2010

John Mass, Chairperson
California Lottery Commission
600 North Tenth Street
Sacramento, CA 95811

Dear Mr. Mass:

The State Controller's Office audited the California Lottery's (Lottery) annuity investment process for the period of July 1, 2007, through June 30, 2009.

Our audit of the Lottery's annuity investment process disclosed that the Lottery does not have formal written procedures for processing, verifying, and approving transactions in relation to the investment portfolio restructure, nor does it have procedures for reviewing and monitoring the restructured portfolio to mitigate risks to its investments.

If you have any questions, please call Andrew Finlayson, Chief, State Agency Audits Bureau, at (916) 324-6310.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

JVB/vb

cc: John Menchaca, Commissioner
California Lottery Commission
Margaret Mims, Commissioner
California Lottery Commission
Joan M. Borucki, Director
California Lottery
Michael T. Ota, Deputy Director
Finance Division
California Lottery
Roberto Zavala, Chief
Internal Audits
California Lottery

Contents

Audit Report

Summary	1
Background.....	1
Objectives, Scope, and Methodology	3
Conclusion.....	4
Views of Responsible Official.....	4
Restricted Use	4
Finding and Recommendation	5

Audit Report

Summary

Our audit of the California Lottery's (Lottery) annuity investment process for the period of July 1, 2007, through June 30, 2009, disclosed that the Lottery does not have formal written procedures for processing, verifying, and approving transactions in relation to the investment portfolio restructure, nor does it have procedures for reviewing and monitoring the restructured portfolio to mitigate risks to its investments.

The purpose of the audit is to determine that controls over the annuity investment process are adequate and that annuity investments made are legal and proper.

Background

The California Constitution, Government Code section 12410 states, "The Controller shall superintend the fiscal concerns of the state. The Controller shall audit all claims against the state, and may audit the disbursement of any state money, for correctness, legality, and for sufficient provision of law for payment." In addition, Government Code section 12411 stipulates that "... the Controller shall suggest plans for the improvement and management of revenues."

Proposition 37, the California State Lottery Act of 1984 (Lottery Act), amended the California Constitution to authorize the establishment of a statewide lottery, to create the California Lottery Commission, and to give the commission broad powers to oversee the operation of a statewide lottery.

Pursuant to Government Code section 8880.67, the SCO may conduct other special post-audits of the Lottery, as the State Controller deems necessary. The Controller or his/her agents conducting an audit under this chapter shall have access and authority to examine any and all records of the California Lottery Commission.

The Lottery Commission and state statute determine the deposit and investment policies of the Lottery. Prize investments consist of zero coupon U.S. Treasury bonds, U.S. Treasury bills, zero coupon agency bonds, and municipal bonds. The Lottery policy is to make an initial cash payment to grand prize winners and invest the balance of the prize winnings in order to make future payments to winners. At the Lottery's Commission meeting on January 28, 2009, the investment policy was amended to include municipal and agency bonds in investment purchases.

On May 13, 2009, the Lottery Commission approved an amendment to the Lottery's investment policy that allowed for the restructure of its investment portfolio to maximize the investment return. The amendment authorizes the Lottery to sell its previously held U.S. Treasury zero coupon bonds and replace them with municipal and agency bonds. In addition, the Lottery Commission approved a contract with Ramirez

and Company, Inc. for advice on and assistance with restructuring the investment portfolio. The contract was for the period of May 14, 2009, through June 30, 2011.

On December 17, 2009, the Lottery Commission amended the Lottery's investment policy that provided guidelines with respect to the management of the annuity investment portfolio. These guidelines specify permitted investments, credit, and reinvestment risk management; diversification of investment in municipal bonds; delegation of managerial authority; and the Lottery staff's responsibilities for the investment process and adoption and periodic review of investment policies.

Prize investments are required for the following Lottery games:

- Scratchers Games

Prizes of \$1 million or more are generally paid in 20 equal annual installments. The Weekly Grand, the Extravaganza 2000, the Twice as Grand, and the Weekly \$2000 Payday top prizes are paid in weekly installments for 20 years. The Decade of Dollars top prizes are paid in annual installments for ten years. The top prizes for the Cash for 20 Years game and the \$750,000 Payday game are paid in annual, graduated payments over 20-year and 25-year periods, respectively. The Make Me a Millionaire game is paid in equal annual payments over a 20-year period.

The Next Millionaire and the California Millionaire top prizes of \$1 million were each paid in a single payment.

- Draw Games

Effective April 1, 1998, Super LOTTO grand/jackpot prizes of \$1 million or more are paid either in 26 graduated annual payments or in a single payment equal to the cash value of a 26-payment annuity, in accordance with the rules and regulations of the Lottery.

As of September 21, 2005, Mega Millions and Super LOTTO grand/jackpot prizes winners no longer must select cash or 26 annual payments at the time of purchase. They now have up to 60 days after the date they become entitled to the prize to irrevocably elect to receive the cash value or the annuitized payments. Payments for all other prize categories are made in a single payment. Investments will purchase only annuities and no cash options.

**Objectives, Scope,
and Methodology**

The purpose of audit is to determine that controls over the annuity investment process are adequate and that annuity investments made are legal and proper. The period under review was from June 1, 2007, through June 30, 2009.

We conducted this performance audit in accordance with generally accepted government auditing standards. We did not audit the Lottery's financial statements. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The objectives of our audit were to determine if the Lottery:

- Complied with the Lottery Commission regulations to maximize all investment opportunities;
- Properly and timely invested funds for payments of off-line and on-line annuitized prizes and determined if all prize liabilities are being fully funded;
- Monitored the investment portfolios to ensure timely redemption of matured investments, and prompt and accurate payments to winners;
- Properly accounted for the investment sales; and
- Evaluated the Lottery's risk adjustment rate of return on investments.

The audit included, but was not limited to, the following audit procedures:

- Reviewing the California Lottery Act, state laws and regulations, and any other applicable policies and procedures related to the annuity investment process;
- Reviewing work performed by any external audit organization, by the Lottery Internal Audits Office, or by any other Lottery units;
- Documenting a description of the internal controls over the annuity investment process encompassing Lottery's policies and procedures;
- Analyzing and evaluating the internal controls for the annuity investment process by evaluating the strengths and weaknesses; and
- Performing tests to determine if control objectives are being properly achieved.

Conclusion

Our audit disclosed that the Lottery does not have formal written procedures for processing, verifying, and approving transactions in relation to the investment portfolio restructure, nor does it have procedures for reviewing and monitoring the portfolio after the restructure. Written procedures are necessary for reviewing and monitoring the restructured portfolio to mitigate risks to the Lottery's investments, as well as for minimizing operational and accounting discrepancies.

**Views of
Responsible Official**

We issued a draft report dated April 22, 2010. Joan Borucki responded by the attached letter dated May 27, 2010. Ms. Borucki concurred that "formal written procedures" are necessary for the Lottery investment portfolio restructuring process that was implemented during the period being audited.

Restricted Use

This report is intended for the information and use of the California Lottery, the California Lottery Commission, and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of the final report, which is a matter of public record.

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

September 8, 2010

Finding and Recommendation

FINDING—**The Lottery lacks formal written procedures for investment portfolio restructuring activities**

Our audit disclosed that the Lottery does not have formal written procedures for the following investment activities:

- Processing, verifying, and approving investment transactions in relation to the portfolio restructure; and
- Reviewing and monitoring the restructured portfolio to mitigate risks to the Lottery's investments.

On May 13, 2009, the Lottery Commission approved an amendment to the Lottery's investment policy that allowed for the restructure of its investment portfolio. The amendment authorizes the Lottery to sell its previously held U.S. Treasury zero-coupon bonds and replace them with municipal and agency bonds. In May and June of 2009, the Lottery sold previously held zero-coupon bonds and purchased municipal and agency bonds. However, no formalized written procedures were in place for processing, reviewing, and monitoring the investment portfolio restructure.

On March 4, 2010, the Lottery provided us with a draft copy of procedures for reviewing and approving investment strategy, proposed investments, and trade execution. These procedures were provided after the exit conference that was held on February 11, 2010. During fieldwork, we noted that these procedures were being followed in the investment restructuring processes along with other investment guidelines. However, the Lottery has not formalized these procedures to make them an official means of communication to investment staff involved in the investment restructuring process.

The lack of formal written procedures can cause inconsistency in the investment process, which may lead to errors, omissions, delays, and unauthorized activities.

State Administrative Manual (SAM) section 20050 states that experience has indicated that the existence of one or more of the following danger signals will usually be indicative of a poorly maintained or vulnerable control system. These symptoms may apply to the organization as a whole or to individual units or activities. Entity heads and managers should identify and make necessary corrections when warned by any of the danger signals listed below:

- Policy and procedural or operational manuals are either not currently maintained or are nonexistent.
- No procedures are established to assure that controls in all areas of operation evaluated on a reasonable and timely basis.

“The Internal Control – Integrated Framework” Report from the Committee of Sponsoring Organizations of the Treadway Commission (COSO) defines one of the components of internal control—Control Activities—as “policies and procedures that ensure management’s directives are carried out and help ensure that necessary actions are taken to minimize risks to achievement of the entity’s objectives.”

Recommendation

We recommend that the Lottery formalize written procedures approved by executive management to ensure that investment activities adhere to the investment policies. These procedures should be specific to, and comprehensive as regards, performing each step of investment processes. In addition, Lottery management should regularly review and update the written procedures, should there be any changes to the Lottery’s investment policies.

Lottery’s Response

Lottery concurs that “formal written procedures” are necessary for the Lottery investment portfolio restructuring process that was implemented during the period being audited. However, we are concerned with the context and implications associated with the findings and recommendations as presented in the audit report.

SCO’s Comment

We are concerned about the risk of the Lottery not having formal written procedures when it entered into the restructuring of its investment portfolio in May 2009. On February 11, 2010, during the exit conference, Investment staff informed us that when the Lottery entered the restructuring of its investment portfolio, they were under a time constraint and were unfamiliar with the new investment process, and that management did not have sufficient time to develop written procedures to support and enhance the execution of the Lottery’s investment policy.

On June 7, 2010, the Lottery provided us with copies of the approved procedures dated March 31, 2010, titled “Bond Transaction Authorization,” Investment Analysis,” and “Portfolio Accountability.” These procedures were provided to us after we issued the draft report dated April 22, 2010, and after we received the Lottery’s response dated May 27, 2010.

**Attachment—
California Lottery's
Response to Draft Report**



May 27, 2010

Mr. Jeffrey V. Brownfield, Chief
Division of Audits
State Controller's Office
P.O. Box 942850
Sacramento, CA 94250-5874

Dear Mr. Brownfield:

The California State Lottery (Lottery) offers the following comments and specific points regarding the recently concluded audit of the Lottery's Annuity Investment Process conducted by the State Controller's Office (SCO). As stated in the draft audit report dated April 22, 2010, the five objectives of the audit were to determine if the Lottery:

1. Complied with the Lottery Commission regulations to maximize investment opportunities;
2. Properly and timely invested funds for payments of off-line and on-line annuitized prizes and determined if all prize liabilities are being fully funded;
3. Monitored the investment portfolio to ensure timely redemption of matured investments, and prompt and accurate payments to winners;
4. Properly accounted for the investment sales; and
5. Evaluated the Lottery's risk adjustment rate of return on investments.

We are pleased that the audit confirms there are no issues with the Lottery's investment processes. This is especially important because the audit covered the time period when the Lottery reassessed long-standing investment practices and implemented changes that better utilized our investment portfolio to increase funding for public education.

Below is the Lottery's response to the recommendations in the draft audit report which is summarized below:

SCO Finding – The Lottery lacks formal written procedures for investment portfolio restructuring activities.

SCO Recommendation – The Lottery should formalize written procedures approved by executive management to ensure investment activities adhere to the investment policies.

These procedures should be specific and comprehensive to performing each step of investment processes. In addition, Lottery management needs to regularly review and update the written procedures, should there be any changes to the Lottery's investment policies.

Lottery Response to SCO Finding:

The Lottery concurs that "formal written procedures" are necessary for the Lottery's investment portfolio restructuring process that was implemented during the period being audited. However, we are concerned with the context and implications associated with the findings and recommendations as presented in the audit report.

The Lottery utilized Project Management disciplines with strong management team participation in undertaking the effort to implement processes for restructuring our investment portfolio. An essential component of the project plan was formal documentation of procedures. The project plan for completing documentation of procedures was shared with SCO staff during the audit.

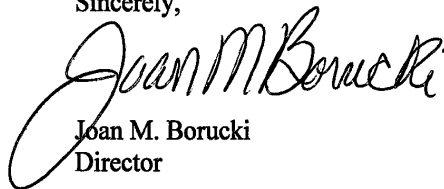
Another key element of the project plan included engaging a consultant, Ramirez and Company, Inc., as an investment advisor to assist the Lottery in developing business processes based on industry best practices. The Lottery's management team also collaborated with the State Treasurer's Office (STO) to develop the processes and controls that would be utilized for the investment portfolio restructuring. The results of these efforts were draft procedures that the report acknowledges existed during the time audit field work was conducted. The report also states Lottery staff was following the procedures together with other investment guidelines.

And finally, in accordance with the Lottery's project plan, formal documentation of procedures for investment portfolio restructuring have been completed. These procedures continue to provide specific and comprehensive processes for performing each step of the Lottery's investment activities. Further, these procedures have been approved by the management team that has been in place since the outset of investment portfolio restructuring activities. The procedures conform to standards established for formal documentation and are subject to regular review.

The Lottery's team responsible for implementing and carrying forth the goals and objectives of the investment restructuring process has been, and remains, vigilant in developing and following investment policies and procedures that ensure there are no undue risks to assets of the Lottery. We would also like to note that the Lottery's independent financial audit covering the same time period found no material misstatements in our financial statements.

Please contact my Audit Chief, Roberto Zavala, at (916) 323-7156 if you have any questions.

Sincerely,



Joan M. Borucki
Director

**State Controller's Office
Division of Audits
Post Office Box 942850
Sacramento, CA 94250-5874**

<http://www.sco.ca.gov>